There’s No Place Like Home...

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The principal residence is often the marital asset that causes the most personal dilemma because it was the home of both parties and their children. Whether one should keep it for personal or practical reasons, the principal residence is the asset that often gives rise to many financial questions due to expenses and ultimate division or disposal of the home.

Expenses

Normally, a couple enjoys tax-related deductions for the mortgage interest and real estate taxes they pay as itemized deductions on their personal tax returns. Mortgage interest may be deducted on up to two qualified residences whose total mortgages do not exceed $1 million, plus $100,000 on a home equity line of credit. Real estate taxes paid on as many properties that the taxpayers own are fully deductible.

Mortgage payments and related costs are not allowed to be added to the personal residence’s basis. Keep in mind that as the mortgage is paid, equity in the house is created. If one party continues, after the date of separation, to pay the mortgage out of separate assets, then that party may receive a credit in equitable distribution for the additional equity that was created by the principal payments. The mortgage interest would not likely generate a marital credit because a tax benefit was received.

It can be tricky to allocate between the parties the real estate taxes and mortgage interest deductions during the period of separation or after divorce. Deductions paid from a separately owned account are presumed to be paid by the owner of the account (regardless of the account’s status for equitable division purposes). In turn, deductions paid from a jointly owned account are presumed to be paid jointly and are allocated one half to each spouse. If one spouse pays the other’s expenses, and the payment is deemed, by an agreement, to be alimony, then the mortgage interest is deducted by the spouse that has included it as income as alimony.

Title, ownership, and usage create a difference when one party is making the payments on the residence. Mortgage payments on the marital residence made on behalf of the payee spouse may be taxable/deductible alimony if the payments meet Internal Revenue Code (IRC) Section §71 requirements. If the payor is the sole owner of the property, listed individually on the mortgage, and is using the property, the payor cannot deduct the amounts as alimony, but can personally deduct the mortgage interest as an itemized tax deduction. If the property is jointly owned and being paid from the payor’s personal account, the payor can deduct half of the mortgage principal and half of the mortgage interest as alimony, and the other half of the mortgage interest as an itemized deduction. The payee reports the amount as taxable alimony, but then gets credit for the principal amount as payment towards the joint debt and gets to deduct the mortgage interest. If there is an agreement and the payee is the sole owner of the property, the payor can deduct the entire mortgage payment (principal and interest) as alimony, and the payee can deduct all of the mortgage interest against the alimony he
or she is taxed on. In the *Leventhal v. Commissioner*, T.C. Memo 2000-92, the payor was allowed to deduct half of the mortgage interest as the alimony payment, and the other half was considered as personal use. In addition, fair rental value can never be treated as alimony for housing expenses that the payor has an obligation for, because it is not a cash payment.

If the parties are joint owners on the property and share the obligations, then the payee can also deduct half of the real estate taxes (the other half as itemized deduction) and half of the insurance payments as alimony. If the payor does not own the residence and is not living there, one must be careful that the payments may not qualify as his principal residence or second residence (which must have been used personally for 14 days) and may not deduct the interest. As will be discussed in detail in the Asset Division section below, in order for the residence to qualify as the principal residence, the divorce agreement must be in place to have ownership directly or through the spouse. Keep in mind, also, that if the parties are filing married separately, the payor can deduct interest on a mortgage only up to $500,000 and interest on a line of credit up to $50,000 of debt.

In addition, utilities can be deducted as alimony if the party is court-ordered to pay them and the requirement is part of the alimony agreement. If, to expedite temporary proceedings (alimony pendente lite), a judge provides that, in addition to specific cash amounts, the payor must continue payments of all other expenses of running the household, such as rent, utilities, gardeners, and the like, these payments could also qualify as alimony.

### Asset Division

The division or disposal of the marital home also has tax consequences. IRC § 1041 states that there is no gain or loss recognition on the transfer of property from an individual to (1) a spouse or (2) a former spouse, but only if the transfer is incident to the divorce. The transferee receives the transferor’s adjusted basis (like a gift) and transferor must be required to give records of the basis as proof. A transfer is incident to divorce if (1) the transfer is within one year after the date which the marriage ends or (2) is related to the ending of the marriage (and is made under an original or modified divorce or separation instrument). There is an exception to the one-year rule that is often applied to the marital residence – that as long as the transfer occurs within six years after the divorce pursuant to a divorce or separation agreement it will be considered as “incident to the divorce.” This could be written in for such items as marital residence, where you want to wait until the children graduate or the house does not sell immediately.

In order to allocate the marital home during equitable division, one must consider the home’s basis, tax consequences, and value. A real estate appraisal or some other agreed-upon method (such as the value on a recently purchased house) may be used to determine the current value of the house. Also, depending on the state and county in which the parties are divorcing, one might consider discounting...
the asset for closing costs and income taxes to be paid if one were to sell as part of the settlement (Carney v. Carney, 2017 PA Super. 169 and Balicki v. Balicki, 2010 PA Super. 134). If one spouse is receiving the asset as part of the settlement, then that spouse must know and have documents in support of the basis of the house. These would include the purchase price, purchase settlement costs, and any fix up costs that would be added to the basis. If the parties have agreed to sell the house, either now or in the future, but hold it jointly, then these details need to be considered for tax purposes.

Under IRC § 121, which concerns the sale of the principal residence, individuals may exclude a gain up to $250,000 while married couples filing a joint tax return may exclude up to $500,000 if certain rules are met. There are three parts to the exclusion rules — ownership test, use test, and prior sales. You must have owned the home and lived in your main home for two years during the five-year period ending on the date of sale. The two years do not have to be continuous: they must be 24 months or 730 days during the five-year period. In addition, during the two-year period ending on the date of the sale, you may not exclude gain from the sale of another home. There are exceptions to the use test. For example, if you become physically or mentally unable to care for yourself or you owned and lived in the home as your main home for a total of at least one year during the five-year period before the sale of your home (i.e., you live in a nursing home).

There are certain exceptions to the exclusion of the gain: If you sell the land on which your main home is located, but not the home itself, you cannot exclude any gain. If you have two homes, the one that you live in most of the time is your main home. If you own a home but live in a separate rented house, the rental is your main home. If only part of the house is used as your main home, only the gain or loss associated with that part of the home is excluded.

As a married couple, you can exclude up to $500,000 if all of the following are true:

1. You are married and file a joint return for the year
2. Either you or your spouse meets the ownership test
3. Both you and your spouse meet the use test
4. During the two-year period ending on the date of the sale, neither you nor your spouse excluded gain from the sale of another home

If the married parties sell the house before the divorce, then they could file jointly and exclude up to $500,000 in gain. However, if they sell the house post divorce, they may be able to exclude up to $250,000 each on their separate individual returns. If one of the parties has been out of the home for more than three years at the time of the sale, the use test would be failed. One could still exclude the gain, however, as there is a relief provision. This provision (IRC § 121(d)(3)(B)) allows a taxpayer who moves out of the marital home to continue to count the time a spouse or former spouse is granted use of the residence by a divorce instrument. The key is that the divorce instrument must be executed. Moving out, by itself, doesn’t allow one to use the former spouse’s use-test results.
The next issue is the ownership test. If the house stays titled in both names post-divorce then the ownership test is met. If the house is transferred to one party through the settlement agreement, however, then the ownership test is not met by the transferor. Therefore, both parties must remain on the title if they are to share in the sale post-divorce. Keep in mind that the marital proceeds most likely will be allocated the same way as other assets were divided and this could cause one party to have more of a gain and therefore pay tax while the other party pays none. Reduced exclusions are available for taxpayers who fail the two-out-of-five-year test because of a change in employment, health, or unforeseen circumstances (which according to the IRS includes divorce and legal separation when under a decree of divorce or separate maintenance).

If the parties would like to transfer the house to one spouse incident to divorce, there frequently are complications related to the mortgage. The party not keeping the house would want to be removed from any mortgage. If the spouse keeping the house needs to refinance they must have sufficient income to qualify for the new mortgage. Once the transfer between the parties is complete, the basis and period of ownership is transferred with the house. Note that the excluded gain allowed is now only $250,000, because of the divorce, unless the recipient remarries before the sale.

**Conclusion**

There are many factors to address with regard to the marital residence. Individuals may find themselves tied to each other post-divorce if the asset cannot be sold or refinanced. It also can cause many issues with tax deductions (and the need for annual coordination) related to any deductible expenses. These issues must be further explored and vetted so that the emotion of parting with the family home is contained.

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